Europe's Big Bang moment: How COVID-19 could reshape real estate portfolios

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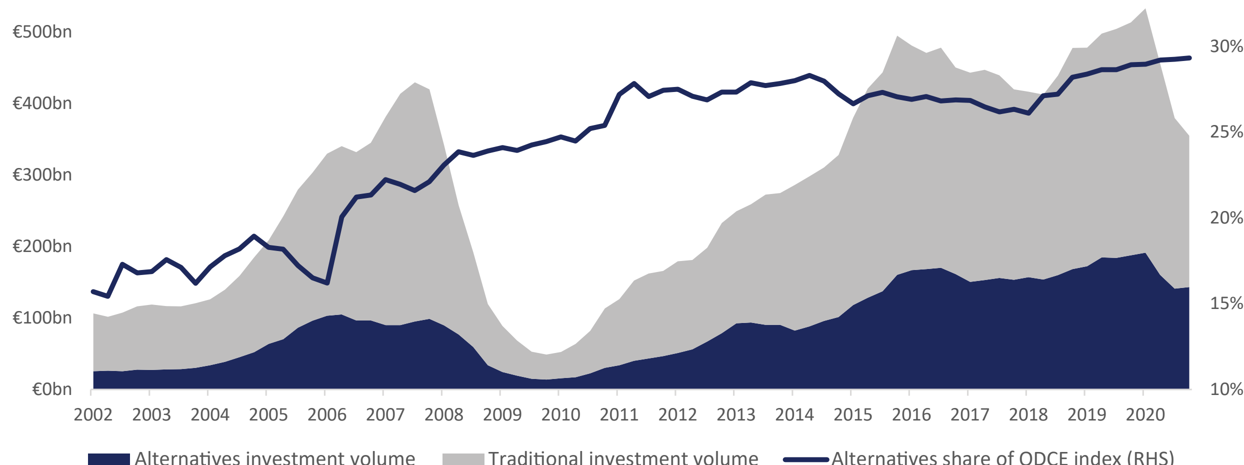
CHART 1: **US 12-MONTH ROLLING PRIVATE REAL ESTATE INVESTMENT VOLUME AND ALTERNATIVES SHARE OF THE US NPI ODCE INDEX**



Source: Real Capital Analytics; NCREIF; Heitman Research

After great disruption often comes great reform. Multilateralism was pursued after World War II to safeguard international security, while the Global Financial Crisis gave rise to regulations designed to improve the stability of the banking system. The COVID pandemic has similarly exposed the need for greater resilience in national health systems and global supply chains. Real estate investors, having historically paused to consider portfolio implications from economic downturns, are now making such reconsiderations in response to the pandemic.

INVESTMENT ACTIVITY DURING THE PANDEMIC

In 2020, real estate transaction volumes declined 32% year-over-year in Europe (and 27% globally), according to Real Capital Analytics (RCA). For many investors, COVID-19 is likely prompting examination of their portfolios. We expect many to rotate toward defensive strategies and/or alternative property types. These alternative sectors – among them rented-residential, student housing, senior housing, and self-storage – have proved resilient during the pandemic. They have generally achieved high levels of occupancy, rent collection rates above 90%, and rising capital values. Further, these sectors are poised to experience rapid growth in occupier demand in the coming decade.

In sharp contrast to the commercial sectors, investor interest in alternatives persisted in 2020. European transactions totalled €71 billion, up by 4% from the three-year trailing average. This drove the share of alternatives in the European investment market to record levels – 28% of volume in 2020, up from 17% five years earlier. The continuation of investment demand in a time of crisis reflects growing understanding of the compelling fundamentals and operational drivers that support these sectors. A secular capital rotation is now underway, driven by increasing familiarity with the alternatives and an overarching search for income.

THE HUNT FOR INCOME

Why does the income profile of alternatives matter? The 2021 Investor Intentions Survey by INREV found that investors consider diversification and income return as the primary reasons for direct real estate investment. As negative yielding bonds have proliferated (now equivalent to a quarter of global investment-grade debt), the income-generating ability of real estate has strengthened the motivation to own property. Within this asset class, alternatives typically offer less downside than the traditional, more cyclical sectors, whether due to income-stabilising regulation, lower supply risk, predictable patterns of demand, or slower rates of obsolescence.

The growth of these sectors in institutional US portfolios over the past 15 years provides a roadmap for their potential growth in Europe. The 2007-08 GFC accelerated the capital rotation to alternative real estate in the US. While the share of alternatives in the US NPI ODCE index had been relatively stable in the years prior to the GFC (approximately 16%), that share jumped to 28% by 2011. The increase proved permanent. The search for secure and stable income that began late in the 2000s cycle was the catalyst for this portfolio adjustment. CBRE data shows the US self-storage cap rate spread over office averaged 200 bps during 2006-10, but 140 bps by 2015-19. Similar tightening is noted in student housing.

RCA estimates that annual investment in US alternatives increased by 73% between 2006 and 2016, from €81 billion to €141 billion; this compares to a 45% rise in traditional sectors. During that decade, the diversity of investor capital, sophistication of operators, and the quantum of investable stock all grew substantially in the alternatives. Heitman played a key role in the institutionalisation of the market, going on to become one of the largest private owner-managers of self-storage real estate in the world. Transaction activity in US alternatives held up relatively well during 2020 too; investment volumes fell by 24% year-over-year compared to 35% in the traditional sectors, as shown on Chart 1.

THE GROWTH OPPORTUNITY

Considerable room exists for expansion of European alternatives. They currently make up only 8% of the European ODCE index (compared to 30% in the US) and only 22% of annual investment volumes during 2017-19 (versus 36% in the US); however, these two regions are by no means identical. Local knowledge is critical in Europe to ensure that operating models are tailored for each market, and to navigate individual country nuances that create useful barriers to entry.

One of these is Europe's regulatory framework, which can enhance income stability. Rent controls in German and Swedish residential enable steady, predictable rental growth across the economic cycle, whereas US rents behave more pro-cyclically. The contrast is even greater on the supply front; land shortages and strict planning regimes constrain supply in European alternatives to a much greater degree than in the US. During 2015-19, the net increase in US senior housing supply (relative to growth in the elderly population) was six times larger than in Europe. In the same period, 1.2 dwellings were constructed for every new household in the largest US metros, compared to only 0.7 in Europe.

Europe's 'big bang' moment – a progressive reallocation of investor capital into alternatives – therefore does not rely on the assumption that these sectors exactly replicate the growth trajectory of more mature markets, such as those in the US. Indeed, residential markets that are quite distinctive (such as those in the Netherlands and Scandinavia) have already become the largest property sectors by volume in their respective countries. European alternatives have their own pillars of expansion instead: needs-based demand, insufficient supply, supportive regulation, privatisation, attractive income return, adequate access to financing, and a widening range

of operators. Expansion of inventory and investment are likely to reinforce one another.

Self-storage offers the most striking example of undersupply. Storage saturation per capita in Europe is less than 1/30 of that in the US, even though Europe's cities are more densely populated and the average home size is half of that in the US. Investors can realise the inherent growth potential of this sector through development and application of greater operational sophistication. During 2020, occupancy and rents increased in most institutional-grade facilities, and collection rates of 97-99% were reported by the leading European storage REITs. Private investors can currently expect unlevered income returns in the 6-8% range across most of Western Europe. Spreads over 10-year government bonds and logistics yields are up to several hundred basis points higher than in the US, with the storage vs. 10-year government bond spread 100 bps higher in the more developed UK market. Compensation for operational and liquidity risk in Europe, therefore, appears generous for investors with sufficient appetite and sector expertise.

Growth potential is also apparent in UK student housing, which now regularly attracts annual investment over €3 billion and last year saw the UK's largest ever private real estate transaction. The foundations for capital rotation toward alternatives were clearly in place before the pandemic; the crisis has simply been an accelerator. Indeed, today's search for resilient returns bears some similarity with the US during 2006-2011; what is new is the adverse structural change in the dominant sectors – office and retail – that was far less evident a decade ago.

WHY THIS TIME IS DIFFERENT FOR EUROPE

The appeal of the alternatives partly results from their resilience across economic cycles. Demand is driven by non-cyclical or "delinked" factors. For example, 80% of UK nursing home admissions stem from critical life events such as a fall or the death of a caregiver. Other life events, termed the 'four Ds' (death, divorce, dislocation, and downsizing), drive household demand for storage. Higher education demand has countercyclical traits; applications to universities typically go up in times of economic stress.

One may then ask, "Why – with such reliable drivers – capital rotation into European alternatives is only taking off now, when in the US it began more than a decade ago?" Two key factors should be considered: 1) the ability to diversify, and 2) the need to diversify.

Capital deployment in the alternatives is much more feasible today than after the GFC, owing to greater transparency, liquidity, availability of financing, and choice and sophistication of operators. For example, deeper market intelligence (through data, broker coverage, and dedicated research consultants) is enabling investors to better screen opportunities and assess risk-adjusted returns. The growth of alternatives-focused REITs (e.g., Aedifica, Vonovia, Shurgard) has provided real-time visibility on sector fundamentals and expanded the active investor pool. Banks have become more comfortable in underwriting loans for alternatives acquisition and development. Markets such as German residential and UK student have grown large enough to enable big-ticket portfolio trades (over €500 million) and lot sizes (over €100 million). More nascent sectors like self-storage and countries like Spain, albeit, remain largely dominated by investors with the skills and resources to aggregate more granular portfolios, build platforms, and develop new product.

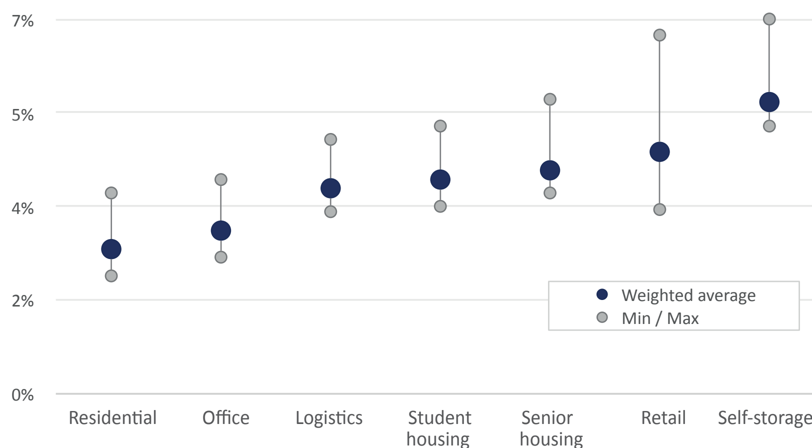
GENERATING ALPHA

The recent performance of European portfolios demonstrates the need for diversification. From 2010-19, US property delivered a 250 bps greater annual return than European property, yet GDP growth was only 80 bps higher. A sector breakdown suggests early US rotation into residential was a source of outperformance. On a trailing five-year and 2020 single-year basis, a European portfolio with sector weights matching the US benchmark portfolio would have comfortably outperformed the European benchmark by an annual return of 90 and 150 bps, respectively. European portfolios are still heavily weighted toward retail and office, and under-allocated to alternatives. Yet the potential benefits from diversification go beyond resilience; these sectors offer income returns appealing in an era of low rates, and are supported by structural occupier trends while headwinds are building in office and retail.

The comparison of prime net initial yields across European sectors in Chart 2 highlights attractive income returns in the alternatives. The exception is residential, where tighter pricing reflects bond-like stability in income and expectations of healthy rental growth. The spread over office, however, is at least 100 bps for student and senior housing, with a 240 bps spread for self-storage. Green Street Advisors have drawn similar conclusions when comparing average yields and adjusting for capex. These 'economic cap rates' suggest spreads over office and industrial of at least 100 bps in senior and student, and over 150 bps in storage. When overlaying capital growth assumptions, the alternatives again rank ahead of office, industrial, and retail.

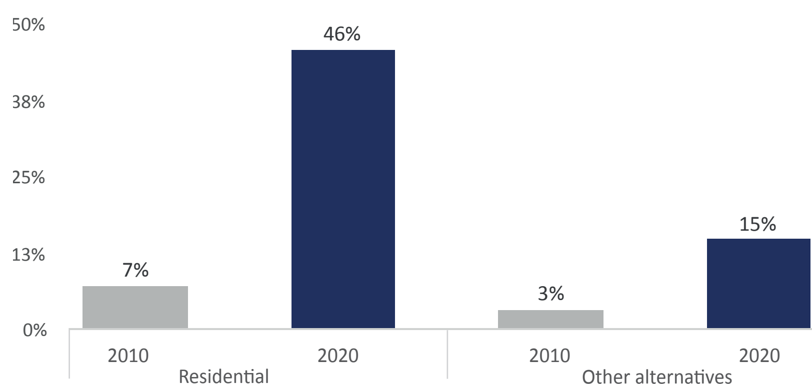
The challenge of achieving return targets in the traditional sectors is likely to grow in the medium term. A wait-and-see approach among buyers and sellers of office buildings remains pervasive, with valuations having shifted little during the pandemic. Concerns about remote working risk are most concentrated in some of the largest markets like London and Paris, but the risk is also material for secondary cities with weaker working-age population outlooks. Across Europe's 100 largest metros, forecasts anticipate the population aged 15-64 to stagnate during 2021-25, with larger cities stealing employment from smaller ones. Secondary assets are also likely to be more adversely affected by capex requirements after the pandemic. The opportunity set for finding good income return in offices is likely to narrow in the coming years. Meanwhile the risks in retail posed by e-commerce are well documented, with a growing number of investors steering clear of the sector. Industrial has favourable occupier fundamentals, but, with prime yields approaching 3.5% in Europe, the sector is keenly priced. With less capacity for yield compression, industrial returns will rely more on rental growth, which has proved elusive in most European markets.

CHART 2: **GDP-WEIGHTED PRIME YIELDS, BY SECTOR, Q4 2020**



Source: Knight Frank; Cushman & Wakefield; CBRE; Catella; Heitman Research

CHART 3: **ALLOCATION WITHIN EUROPEAN REIT UNIVERSE, %**



Source: EPRA

RISKS AND OPPORTUNITIES

Alternatives may have needs-based demand and delinked performance, but every sector has idiosyncratic risks to consider. These may include concentration risk in the occupier base, the reputation and credit quality of the operator, and changes in the regulatory environment.

For example, overreliance on foreign students contributed to a fall in student housing occupancy to 50-60% in Dublin and Barcelona in 2020. After the pandemic, geopolitical tensions will still warrant scrutiny of source country exposure (e.g., Chinese students to the UK). In senior housing, overreliance on state-funded residents was already squeezing UK operator margins before the pandemic; fiscal tightening could become a key risk as it did in the early 2010s. The self-funded care model offers some protection by relying more on the substantial assets held by the elderly, such as home equity.

We view the operational intensity of alternatives as providing more levers for value creation. Through rigorous screening, investors may find operating partners and long-term relationships that enhance the value of the underlying real estate. One such factor is sector expertise – which is yielding greater rewards due to the pandemic, with prospective tenants in senior and student housing now much more focused on safety and quality. Operational and reputational risk can be further managed through appropriate lease structures and branding strategies.

REIT allocations are already responding to these fundamental market changes. The residential share of the European REIT universe increased from 7% to 46% during the decade from 2010 to 2020. Allocation into the more nascent alternative sectors rose from 3% to 15%, but it remains far below the 56% share in the US REIT universe. The scale of the opportunity points to a decades-long process of capital reallocation in Europe. Today, private alternative assets are trading at lower prices than in the public markets – presenting a compelling opportunity for investors in direct European real estate.

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